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ATOZ TAX ALERT

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Change to the tax treatment of US branch structures under US-Luxembourg tax treaty

On 22 June 2016, a draft law was submitted to the Luxembourg Parliament anticipating an upcoming amendment to the US-Luxembourg double tax treaty (DTT).

The aim of this amendment is to stop situations of double non-taxation resulting from different interpretations of the permanent establishment (PE) concept in Luxembourg and the United States.

Example: Status quo

- US-source income is paid to a Luxembourg resident company that is exempt under Luxembourg tax law and the applicable DTT as it is considered to be attributable to a PE located in the US;
- At the same time, under US tax law, no taxable presence exists and the income is exempt in the US;
- Under these circumstances, neither the US nor Luxembourg would tax the income realised through the activities performed by the PE. This situation would result in double non-taxation.

Under the amended DTT rules, the US will be allowed, under certain conditions, to deny DTT benefits and in particular to levy withholding tax in accordance with US tax law on interest, royalty and dividend payments deriving from US sources to a Luxembourg company if the income is not taxed in Luxembourg (because for Luxembourg tax purposes the income is attributable to a PE located in the US or a third country).

However, taking the example of a Luxembourg resident Company with US source income, the denial of treaty benefits by the US will only be possible if:

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- The income which is considered as attributable to the foreign PE is taxed at a combined aggregate effective tax rate which is lower than the lesser of either 15%, or 60% of the Luxembourg statutory rate;

  OR

- Under Luxembourg tax law, the income is attributable to a PE which is located in a third country that does not have a comprehensive DTT with the US, unless Luxembourg includes the PE income into the taxable basis of the Luxembourg head office.

Even where one of the above conditions applies, the competent authorities may still decide via a mutual agreement that treaty benefits should be granted. A possible justification would be, for example, the existence of tax losses.

According to the draft law, the changes to the applicable tax treaty will apply retroactively as from the publication of the Luxembourg law even though the relevant protocol is still in negotiation (this protocol will also include additional provisions). This means that if the Luxembourg legislative process can be finalised this summer, the change to the DTT (by means of a protocol) will apply retroactively as from then, with no regard to when the protocol is finally signed.

Taxpayers that have implemented US branches of Luxembourg companies into their structures should already be aware of the on-going discussions regarding the US-Luxembourg DTT initiated by the US Internal Revenue Service more than a year ago.

Given that US branch structures will soon become inefficient, taxpayers need to urgently develop a strategy to manage their business activities in a different fashion. Potential replacement structures will have to be tailored to each specific set-up with careful consideration of the tax requirements in all jurisdictions concerned.

Can we help? Do you have further questions?

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